Brexit: What will the United Kingdom's withdrawal from the European Union mean for investors?

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Global Macroeconomic Investment Committee

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On June 23, 2016, the United Kingdom (UK) held a non-binding referendum on whether to remain in the European Union (EU) or to leave – the vote was colloquially known as "Brexit," for British exit. To the surprise of many, including politicians in Britain, in Europe, and around the world, and to capital markets, a narrow majority of 51.9% voted to leave the EU. At the time, this roiled global equities and the British pound, and the UK's prime minister, David Cameron, offered his resignation effective upon the selection of his replacement. Three weeks later, Theresa May succeeded Cameron, avowing "Brexit means Brexit" and that there would be no reconsideration of the vote. Nearly five months later, the decision remains unchanged, but little action has been taken on this unprecedented event. We are issuing this brief research note to review what led up to Brexit, what happened, what comes next, and what it means for our clients and investors in general.

Background: What Led Up to Brexit?

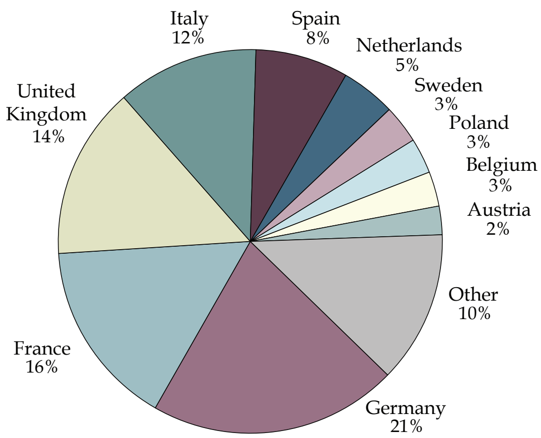
The EU is a multi-national entity that comprises 28 member states.

Source: Europa.eu

It was originally formed in 1957 as the European Economic Community (EEC) among six nations in Western Europe, and was intended to promote integration among the different countries as a way to counteract the nationalism that led to centuries of conflict culminating in World War II. The UK, which comprises England, Scotland, Northern Ireland, and Wales, joined the EEC in 1973 in its first enlargement. Over the years, the integration among member states has expanded to become the world's largest common trade market, with free flow of goods, services, and labor; deepened to include political, as well as economic, coordination; and broadened to include many of the countries of the former Soviet bloc.

Additionally, many (but not all) of the members have adopted the euro as a unified currency.

EU GDP 2013: €13.07T/$17.99T (World Bank)



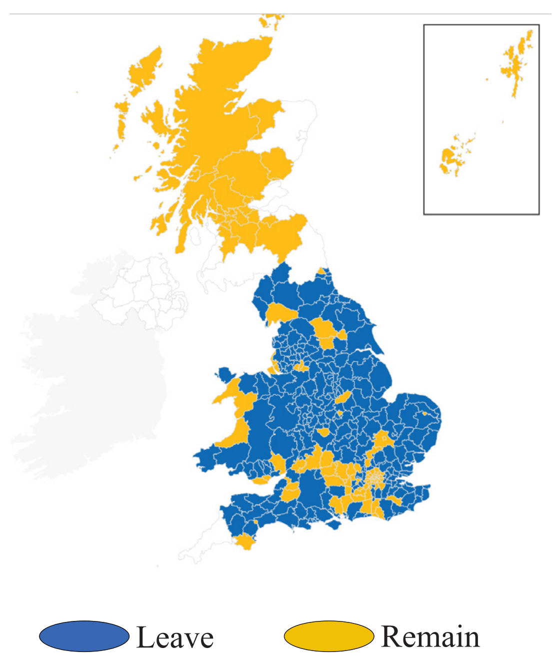
Source: Eurostat. Represents 2013 data.

The EU, as it was renamed in 1993, espoused a goal of "ever closer union" among its members, and has never had a member state leave – until, perhaps, now.

The UK has held a leading role in Europe and the world for centuries. It is currently the second most populous country in Europe and has the third largest economy (following Germany in both categories). Yet despite over 40 years in the EU, the UK remained somewhat apart. Most notably, it never adopted the euro, retaining the pound sterling as its currency. Additionally, many in the UK were concerned that as the EU continued toward ever closer union, national sovereignty of the member states was gradually being eroded in favor of supra-governmental European authorities. These authorities were also perceived as being elected in a less democratic manner. Key disputes that emerged in the common market were over immigration and labor flows (the UK wanted to limit entry from the EU), bureaucratic regulation (from financial to business to product labeling), and net flows of "infrastructure funds" to/from Brussels, the de facto capital of the EU.

In 2013, seeking to appease "Eurosceptics" in his Conservative Party, Prime Minister Cameron vowed that if the Conservatives won a majority in Parliament in 2015, he would seek to negotiate better terms for UK membership in the EU, and then hold a referendum on whether to Remain or Leave. The Conservatives did achieve a majority, and Cameron followed through with his promised talks through the winter of 2015-16 and with the national vote, announced in February 2016 for June. Politically, the Conservative Party split between supporters of remaining in the EU and leaving, while the leading opposition party, Labour, largely favored remaining in the EU. Geographically, support to Remain was stronger in greater London, Scotland, and Northern Ireland, whereas the rest of England and Wales tended toward the Leave camp. Initial expectations that the Remain camp would win a convincing majority gave way to a surprisingly tight race, followed by perhaps the biggest surprise: a victory for those who wanted to Leave. It appears that explicitly tying a vote for Leave to restrictions on immigration was crucial in boosting support for that side.

Brexit Vote Map



Source: Bbc.com

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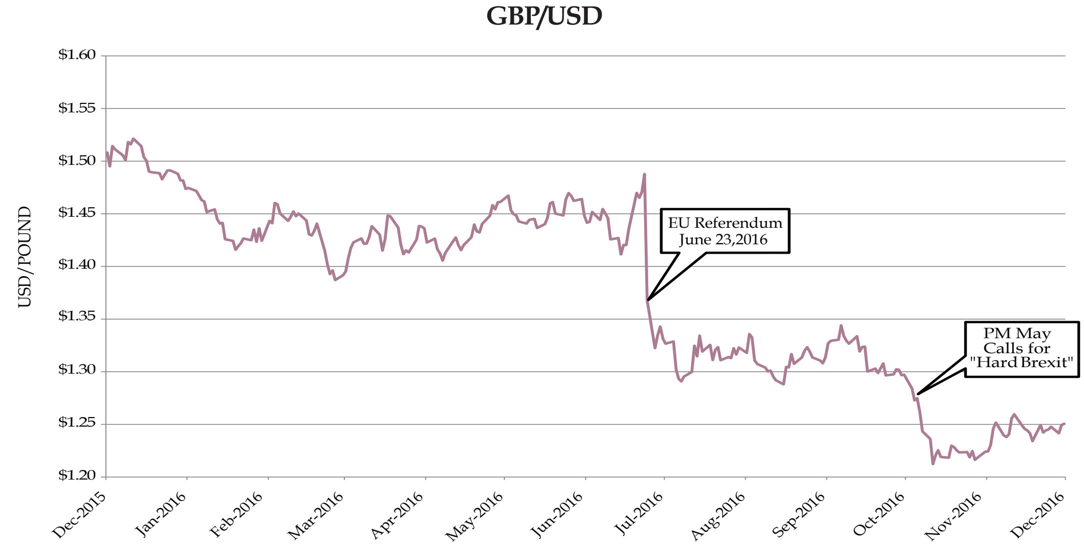

Source: Bloomberg through December 2016.

What Happened?

Despite narrowing polls that showed a too-close-to-call outcome just before the vote, capital markets did not seem to adequately price in the uncertainty, perhaps because those most involved in the British financial industry are centered in London, where sentiment to remain in the EU was high. Indeed, the British pound sterling even modestly appreciated in value on the day of the vote. This proved ephemeral; the next day, the sterling tumbled by over 10% to its lowest value in 30 years. In the following weeks, the currency briefly fell below $1.29 USD/GBP before settling into a trading range of $1.30-$1.35 USD/GBP. Similarly, risk markets had immediate negative reactions to the news, with some European and Asian equities losing as much as 10% in local currency. In contrast, flights to safety led to short-term gains for long-term government bonds, especially U.S. Treasuries. Subsequently, though, markets proved to have overreacted, as they often do, and equity markets rebounded in short order, recouping their losses.

Outside of markets, the most notable result was the departure of Prime Minister Cameron, who led the campaign to remain in the EU and staked his political future on the outcome of the vote. May, his successor, had also backed the Remain side, but insisted that "the public gave their verdict" and she would abide by it, ruling out calls for a second referendum. Jeremy Corbyn, the leader of the opposition Labour party which strongly backed Remain, found his position similarly precarious, but withstood an internal challenge to his authority in September.

For over three months following Prime Minister May's accession, seemingly little took place apart from the creation of a Department for Exiting the EU. Then, at the start of October, May announced that the UK would formally begin exit negotiations by the end of March 2017. Central among her priorities for the withdrawal was taking back the power to control immigration. Since the EU's rules permitting people to move across national frontiers are a core principle of the common market, her tough stance was interpreted as a bid to make a clean break from the EU, known as "hard Brexit," which creates greater potential for uncertainty and disruption. In response, the sterling fell once again, to a $1.20-$1.25 USD/GBP trading range. Further compounding the drama, a month later the British High Court ruled that, despite May's claims to the contrary, the British Government had to seek approval from Parliament before it could begin the process of exiting the EU, which served to emphasize the lack of clarity on the path forward.

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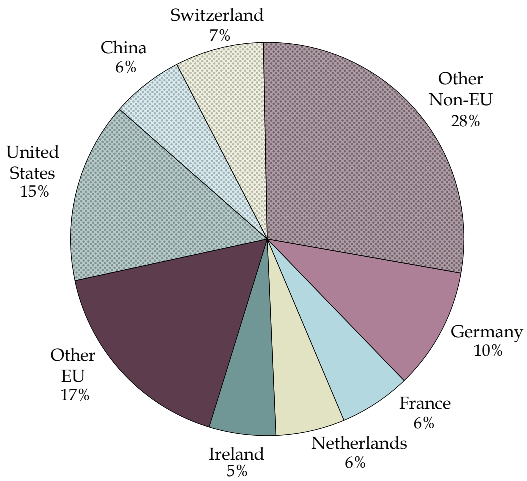
Total UK Exports(2015): £304B/$457B



Notes: *non-solid pattern indicates Non-EU countries

Source: HM Revenue and Customs, National Statistics. Represents 2015 data.

What Comes Next?

A member state wishing to leave the EU must begin the process by invoking Article 50 of the EU Treaty, which then leads to a period of negotiations lasting up to two years. Triggering Article 50 would result in changes to British domestic laws, which is why the Court ruled that Parliament must also become involved (only their new legislation may override existing legislation). The Court's ruling could possibly derail Brexit if Prime Minister May cannot muster the votes, but prevailing views are that it would only delay it past the March date that she had planned. A postponement could push it until or after elections are held in other major European states – France in spring 2017, Germany in September 2017.

Assuming there are no new shocks that upend the current situation, when negotiations finally begin, the outcome is quite uncertain. The prevailing belief is that the EU will try to drive a hard bargain to deter other states from considering leaving as well. The UK is pushing to limit immigration from the EU, to maintain trade access to the EU open market analogous to what other European non-EU states such as Switzerland or Norway have, and to allow its financial sector the same access to Europe as it has now, while the EU seeks the opposite. The EU comprises nearly half of British exports, so the impact of losing access to the common market would be substantial.

One view is that compromise will allow the UK to win on immigration and trade, but lose on financial access (or potentially to require a considerable payment to the EU to maintain the City of London's regulatory "passport" to Europe). As German Chancellor Angela Merkel, the preeminent Continental leader, faces a domestic election of her own with popular demands for limitations on immigration, she may have incentives to negotiate on this issue that appears supremely important to the UK.

Other effects of Brexit with hard-to-foresee consequences include: What will be the impact of the removal of infrastructure funds from the EU (despite conflicting claims during the election, most of the UK outside of London receive net positive inflows)? Could the question of Scottish independence, which lost 55%-45% in 2014, be reopened – since Scotland favored remaining in the EU, perhaps it could re-enter after leaving the UK? Will relations between Ireland and the UK, which have relied in part on both being EU member states with freedom of movement across the Irish-Northern Irish border, become unstable again?

Of particular concern is whether other EU members will seek to withdraw from the union. Both Brexit and the recent upset victory by Donald Trump in the US presidential election are signs of rising populist, anti-establishment sentiment worldwide, with nativist and protectionist implications. These are the natural consequences of living in a low-growth world: the disruptions of globalization negatively impacts more people as there just are not enough gains to be spread around. European political parties that seek to weaken or break-up the union, previously considered on the fringe, have been empowered. The most troublesome development would be if a member state that is on the euro followed suit – disentangling an economy that uses the common currency would be even more complicated and disorderly.

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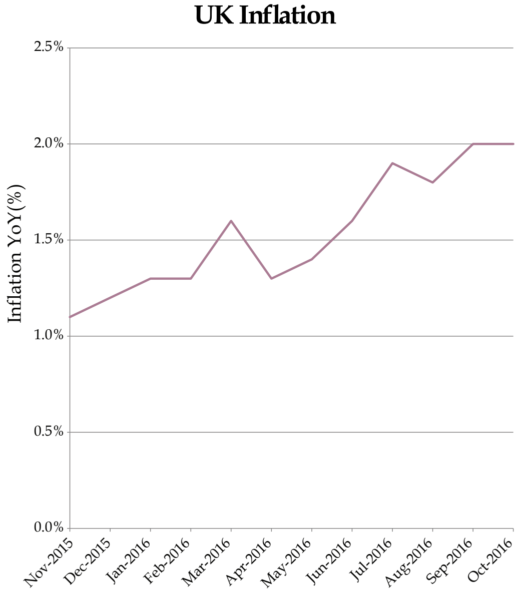
What Does it Mean for Investors?

The uncertainty over the timing, scope, and outcome of negotiations, including the potential impacts on international trade and finance, could be disruptive to markets. There is likely to be a significant negative hit to UK growth and a smaller one to EU growth. In turn, this could lead to further interest rate cuts by the European and British central banks in order to preserve whatever fragile recoveries may be happening. The immediate impact on U.S. growth is probably small, beyond requiring U.S. firms that have used the UK as their access point to Europe to open offices elsewhere in the EU. Doubts about the outcome of the Brexit negotiations could lead the U.S. Federal Reserve to further delay increasing interest rates, resulting in positive impacts on U.S. equity and bond prices. On the currency side, the British pound has already taken two hits, and its "new normal" value has priced in the uncertainty. This decline may show up as increased UK inflation, which has risen slightly since the vote and is forecasted to rise as high as 3.5% next year.

The Bank of England may well find itself forced to choose between raising interest rates to fight inflation and sticking with the current loose policy to combat a weakening economy. Furthermore, the flight to safety that followed Leave's victory in the Brexit campaign strengthened the U.S. dollar and the Japanese yen, but when disaster failed to ensue, markets became sanguine again about risk assets. This is likely because the negative impact of Brexit is both uncertain and more long-term in nature, whereas countervailing central bank stimulus would take place sooner: buy today, worry later.

UK Inflation



Source: Bloomberg through October 2016.

Over the short-to-medium-term we expect dampened expectations for UK and non-UK EU stocks, which respectively constitute 7% and 12% of global equities by capitalization. Barring any developments such as another member state voting to exit the EU, we believe that the big moves, (especially resulting from hits to exchange rates) have probably already happened and are priced in. At the same time, when negotiations begin, and as they proceed, there will no doubt be surprises. Volatility is likely to be heightened, and investors should be prepared with well-diversified portfolios – forewarned is forearmed.

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